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TRIVARIATE RESEARCH

NOW IS A GOOD TIME TO FOCUS ON DIVIDENDS

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SUMMARY

We decided to look in detail at dividend-related strategies given the massive shift in the perception about the path of interest rates. This report is part of our ongoing research on capital use and its consequences (previously we conducted event studies recently on buybacks and deals). After a record number of cancelled dividends in 2020, we are now seeing more companies expand their dividend. At the same time, more companies are expanding their buyback programs than ever today.

We think the timing is particularly good to investigate dividend as a strategy today given the pending Fed lift-off, and importantly, with valuation dispersion very wide among the dividend yielding stocks (signaling potential opportunity). Moreover, and a potential surprise to some, a basket of dividend-expanding stocks has outperformed our hyper-growth universe since 2010, meaning investors may not realize the sustained excellence of this investment approach.

Clearly, the market rewards companies initiating a dividend, and dividend expanders more than cutters or cancellers. However, as we observed in our prior work on buybacks, the market does not reward or penalize companies for their buyback behavior in aggregate. Companies that reduce their buyback or even cancel it do not have cumulative performance that is substantially different than those that keep expanding their buyback. Hence, while buybacks might be a great strategy for a company with truly cheap shares or an inflecting business, in aggregate **what companies do with their dividend has a big impact on their long-term performance, whereas what they do with their buyback does not.**

Obviously, it is challenging to provide the perfect historical analog to evaluate. For instance, the CPI in 2015 was substantially lower than today's print. Nonetheless, many investors ask us what happened in and around the previous set of lift-off and hikes, so we evaluated the various dividend strategies one-month before and 3-months after each Fed hike since the Financial crisis.

Bottom line: Growing the dividend through the hiking cycle seems by far the best strategy. Having your yield above your peer-group (level) did not help in general. If you have no dividend now, starting one is not a bad idea. Cutting the dividend, or even leaving it unchanged was generally penalized.

CONCLUSIONS

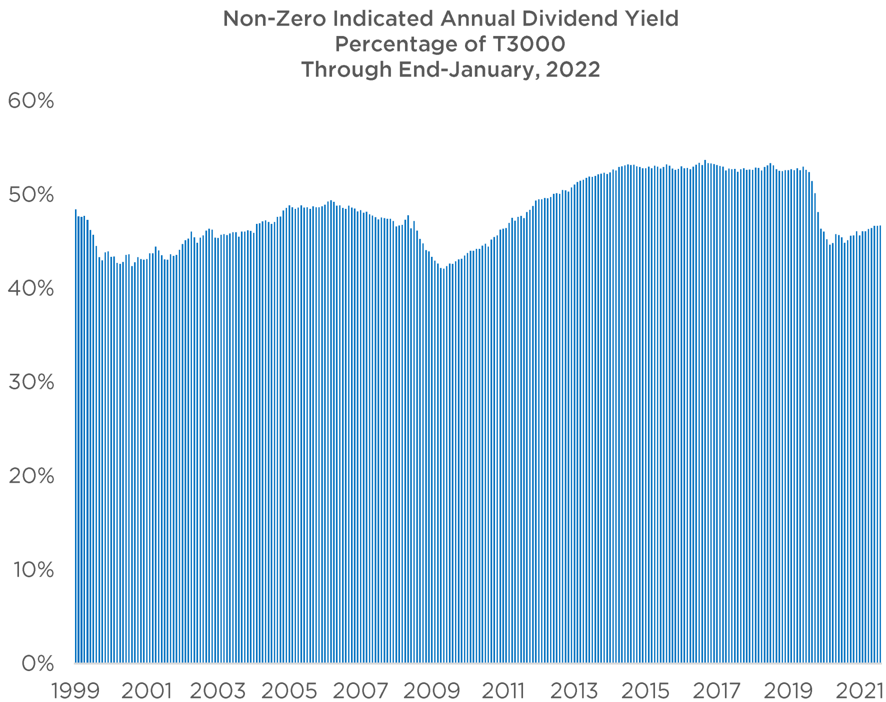
Dividend expansion and initiation: We studied the short-term behavior of companies initiating or expanding their dividends since 1999. Expanders continued to outperform for three weeks after their dividend increase in aggregate, even though they also outperformed on average prior to the announcement. This indicates that it is not too late on average to invest following the announcement. Similarly, companies that initiate a dividend, continue to outperform for 15 days following the announcement. Over the long-term, outperformance continues for expanders for 18 months on average, even though many strongly outperform the 1.5 years prior to the expansion. Those that initiate a dividend also perform well beforehand, but alpha peaks earlier for cutters than for expanders.

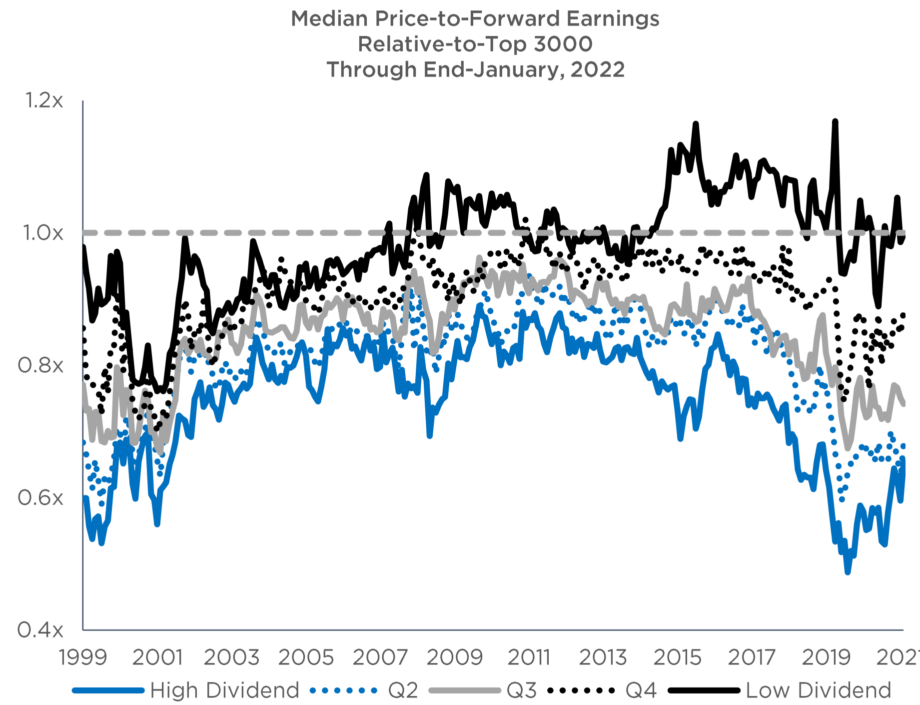
Dividend cut and cancellation: Similarly, it is not too late to sell dividend cutters / cancellers following their announcement. Stocks that announce a dividend cut lag prior to their announcement, but trough nine days after the announcement. Dividend cancellers lag by 200bps on a beta-adjusted basis for the ten trading days prior to announcing a cut, then also lag another 150bps after the announcement. Dividend cutters and cancellers STRONGLY underperform prior to their announcements and drag negative alpha for about five months more for both on average. Cancellers (who survive) start to beat the market by nine months after their announcement.

Stock picking methodology and ideas: We have two quantitative models that specifically forecast returns among high dividend-yielding stocks, one for junk and one for everything else. Overall, the high yield junk model is more focused on balance sheet trends that help with dividend coverage, valuation, and avoiding heavily shorted stocks (where the short thesis is often a pending dividend cut or cancellation). Our non-junk high yield model is more focused on income statement and stability. In summary, the non-junk high yield model is focused on “offense” and the high yield junk model on “defense” when it comes to dividends. Buy and sell ideas come from dividend expanders that screen well in our models or dividend non-growers / cutters / cancellers that screen poorly in our models. Ideas are shown on slide 14.

THE HIGHER THE DIVIDEND, THE LOWER THE MULTIPLE

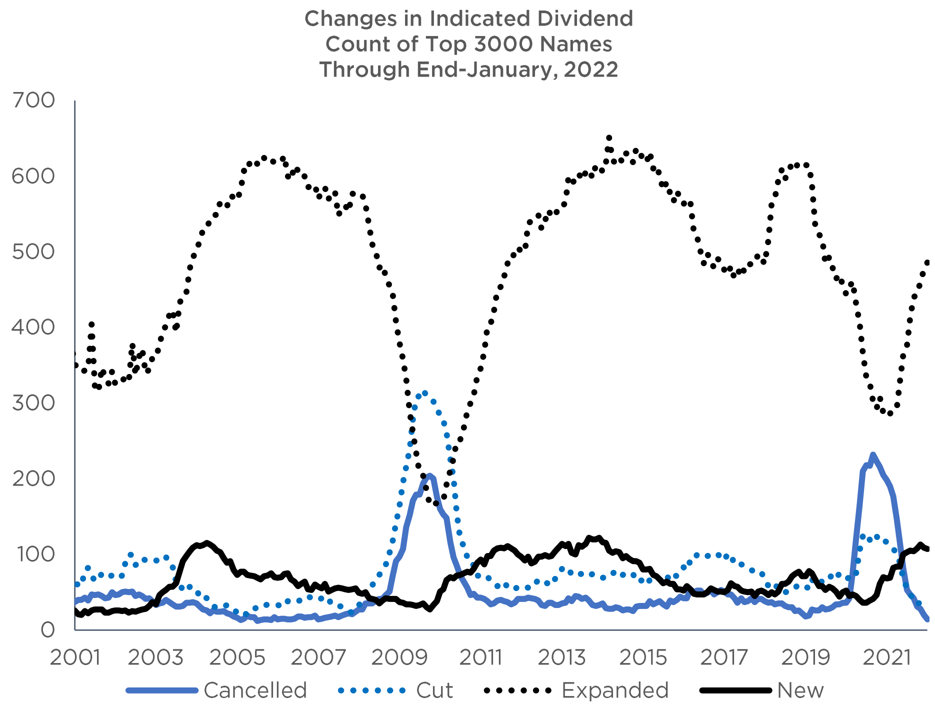
With the massive shift in perception of rates, and our ongoing research on capital use and its consequences (we have conducted event studies recently on buybacks and deals), we decided to look in detail at dividend-related strategies and the markets reward and penalties. For context, just less than 50% of the top 3000 US equities offer a dividend today (left chart). Several cancelled during the worst part of COVID, lowering the percentage from where it remained steady through the second half of last decade. The market has always paid lower multiples for higher dividend yielding companies, because in aggregate they grow slower or see fewer organic growth opportunities. But the valuation discrepancy among the companies with dividends has materially widened in the last two years (right chart) with high yielders near 20-year lows on relative price-to-forward earnings.

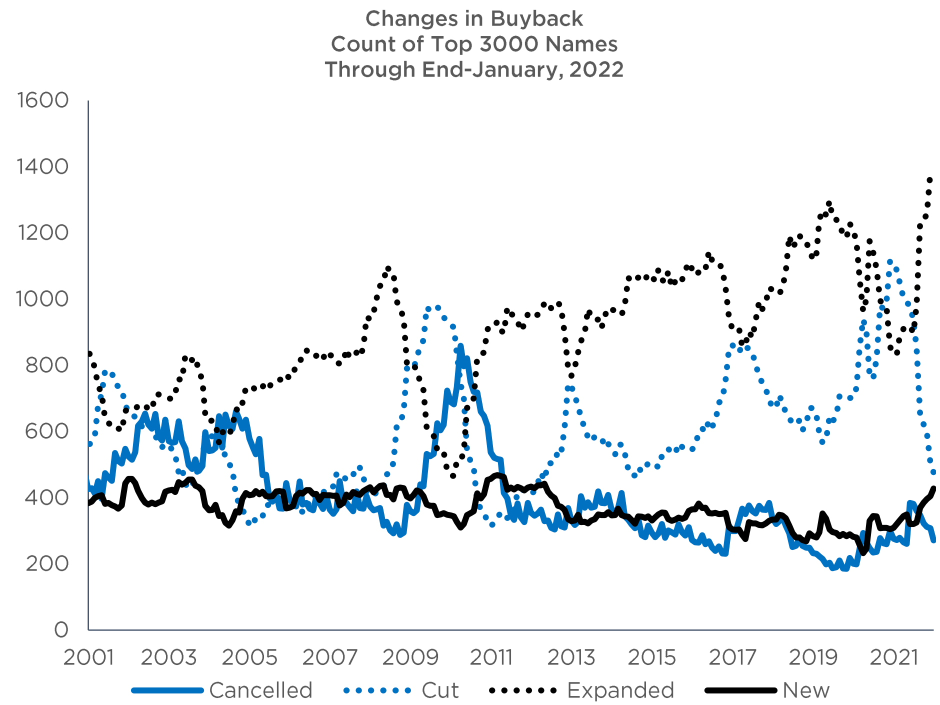




BEHAVIOR RHYMES 2009 WITH RECORD BUYBACK GROWTH TODAY

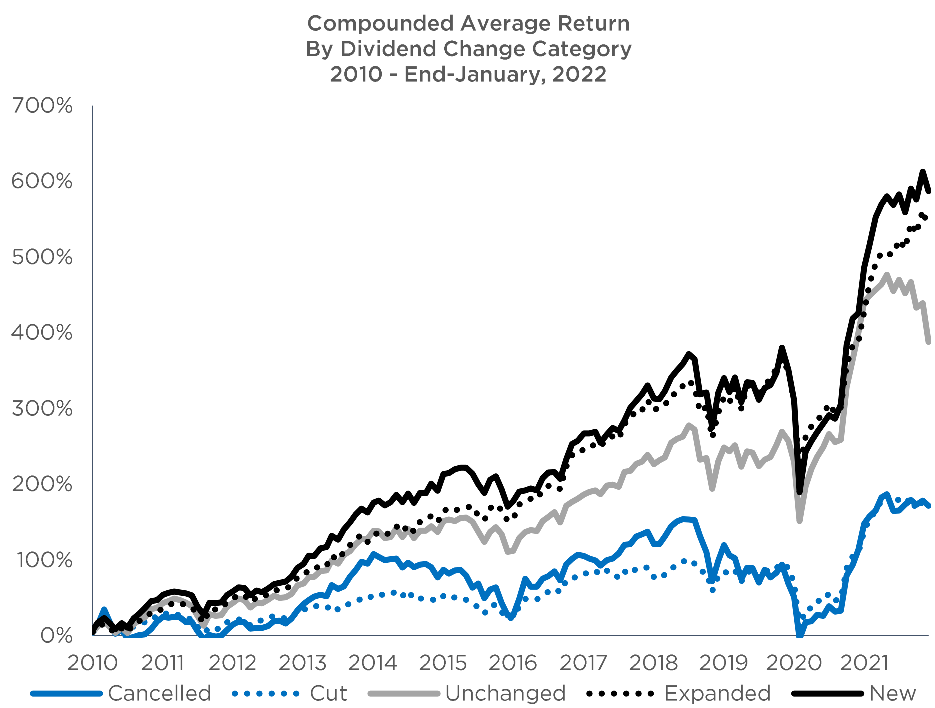
Given that we observed that buybacks were generally not a good use of capital in our prior work, we were curious if we there has been any aggregate change in shareholder return strategies from companies of late. We observed the number of companies among the Top 3000 US equities that are altering (initiating, cancelling, expanding, or reducing) their shareholder return strategies on these two key metrics. Overall, more companies appear to be altering their behavior in a similar manner to the financial crisis and the subsequent recovery. After a record number of cancelled dividends in 2020, we are now seeing more companies expand their dividend again (left). About 500 fewer companies are doing any buybacks today than 18 months ago out of the top 3000 (right), but a record number are also increasing their buybacks. We also saw this behavior following the financial crisis, but we have never had more companies increasing their buybacks than today.

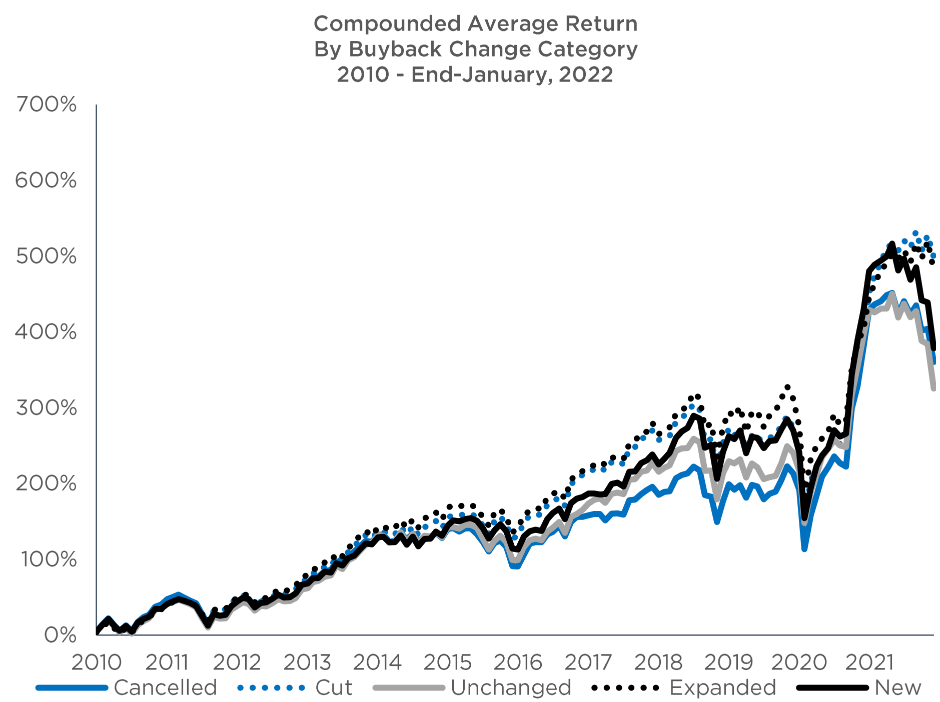




YIELD AND BUYBACK RETURNS – BUYBACKS DON'T SEPARATE

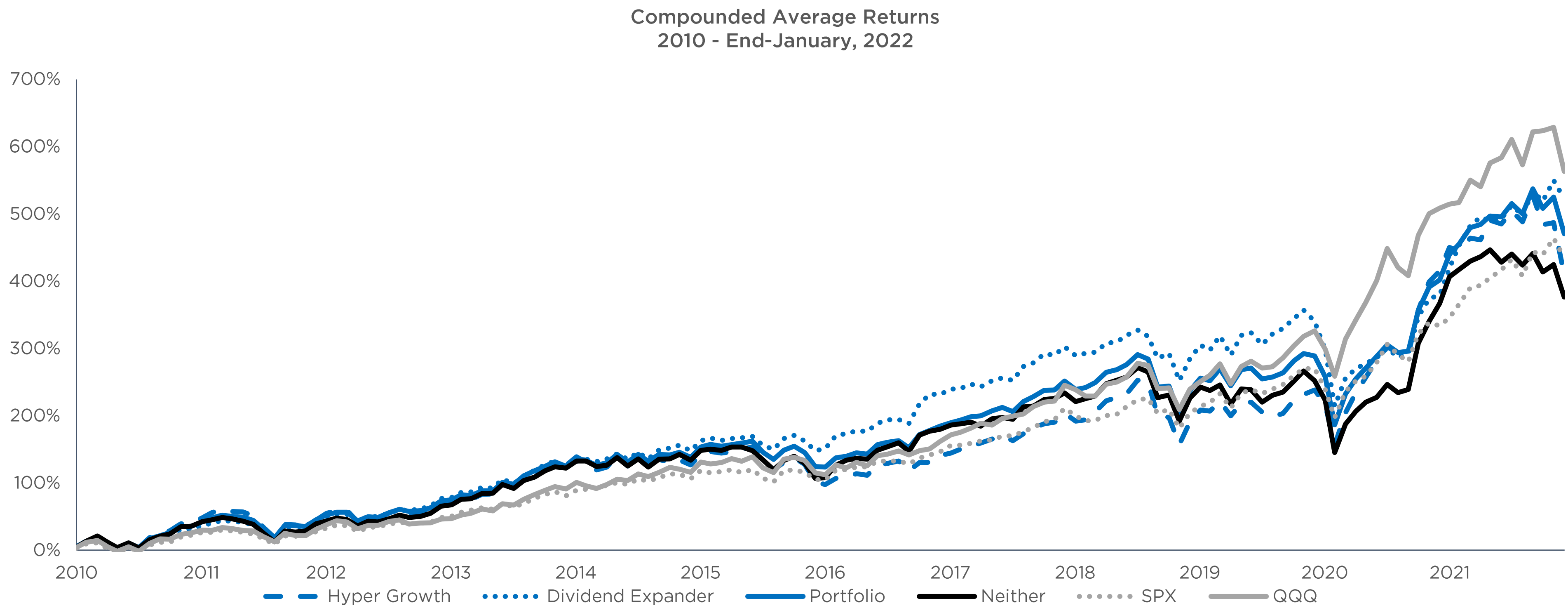
Next, we focus on the distribution of outcomes for these behaviors. Clearly, the market rewards initiating or expanding a more than those cutting or cancelling (left). However, as we observed in our prior work on buybacks (right) the market doesn't materially reward or penalize companies for their buyback behavior in the aggregate. Companies that reduce their buyback or even stop it do not have cumulative performance that is substantially different than those that expand their buyback. Hence, while buybacks might be a great strategy for a company with truly cheap shares or an inflecting business, in aggregate the market seems to differentiate between companies much more on dividend than on buybacks.





IS A COMBO OF GROWTH STOCKS AND DIVIDEND EXPANDERS GOOD?

Given that growth stocks have worked so well since the Financial Crisis as rates rose, we wondered how a basket of dividend expanders performed. It is interesting to note (blue dotted line) that dividend expanders have outperformed the hyper growth basket since the beginning of 2010, with a portfolio (50%-50% hyper growth / dividend growers) beating the SP500 but lagging the Nasdaq over that same time frame. Stocks that were not either hyper growth or a dividend expander, as a basket, lagged the most.



YOU MUST EXPAND YOUR DIVIDEND WHILE THE FED'S HIKING

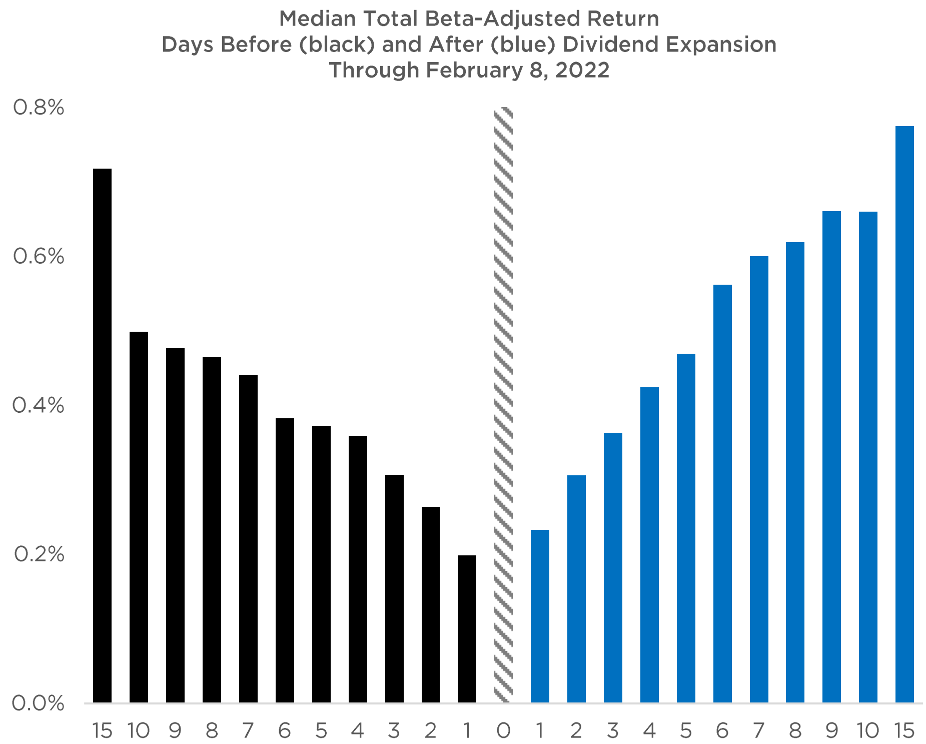
It is challenging to provide the perfect historical analog to evaluate. For instance, today's CPI print was well above the 2015 levels. Nonetheless, many investors ask us what happened in and around the previous set of lift-off and hikes, so we evaluated the various strategies one-month before and 3-months after each Fed hike since the Financial crisis. Growing the dividend through the hiking cycle seems by far the best strategy. Having your yield above your peer-group (level) did not generally help. If you have no dividend now, initiating one is not a bad idea. Cutting, or even leaving the dividend unchanged was generally penalized.

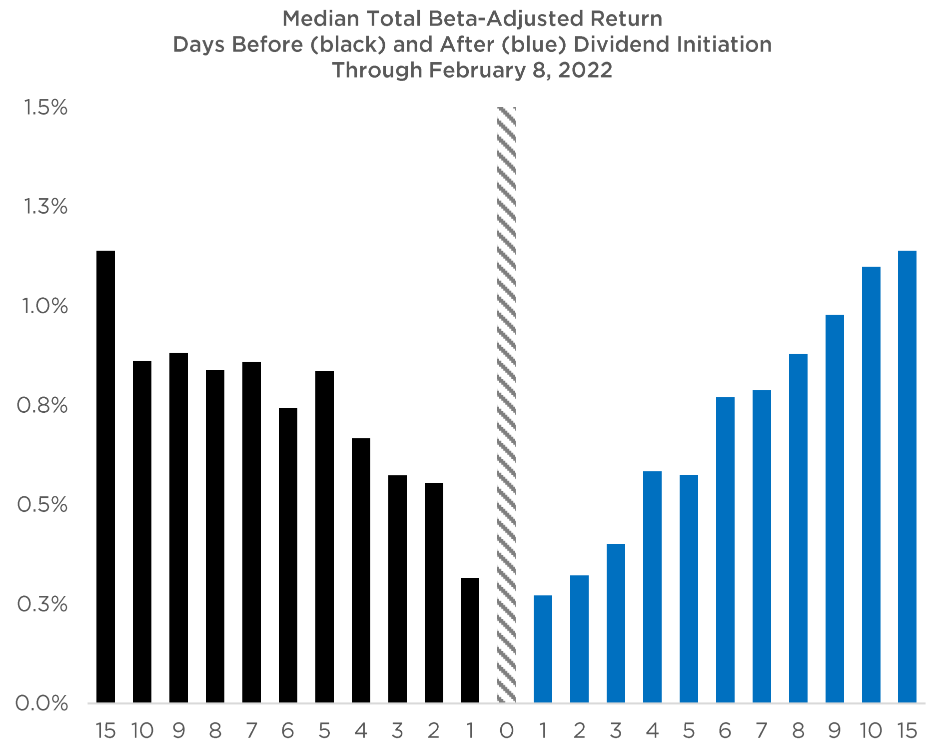
Beta-Adjusted Returns
Select Signals

Signal	11/13/2015 to 3/17/2016	11/15/2016 to 3/20/2017	2/10/2017 to 6/13/2017	5/12/2017 to 9/12/2017	11/13/2017 to 3/16/2018	2/16/2018 to 6/19/2018	5/11/2018 to 9/11/2018	8/24/2018 to 12/26/2018	11/27/2018 to 4/1/2019	Mean	Median
Group-Relative Indicated Annual Dividend Yield	2.1%	(0.7%)	(2.1%)	(3.5%)	(1.2%)	1.9%	3.2%	0.5%	(1.1%)	(0.1%)	(0.7%)
Dividend Cancelled	(3.6%)	(5.3%)	(9.1%)	(1.1%)	(2.8%)	2.9%	(5.9%)	(24.7%)	(11.0%)	(2.3%)	(1.9%)
Dividend Cut	0.4%	(3.5%)	(6.5%)	(6.4%)	(7.7%)	4.4%	0.0%	(16.4%)	(7.0%)	(6.3%)	(4.9%)
Dividend Expanded	0.4%	0.2%	(0.9%)	(0.8%)	2.0%	5.2%	(0.4%)	(9.0%)	(1.0%)	4.0%	4.0%
Dividend Initiated	(3.1%)	3.6%	(8.1%)	(0.5%)	0.5%	6.7%	3.5%	(11.0%)	1.3%	1.4%	(0.1%)
Dividend Unchanged	(4.4%)	(4.4%)	(4.3%)	(1.4%)	1.7%	9.9%	1.3%	(12.0%)	(0.5%)	(3.6%)	(4.0%)
Hyper Growth & Dividend Expander Portfolio	(6.3%)	(2.4%)	(0.9%)	(2.8%)	1.3%	8.4%	0.5%	(11.5%)	(1.0%)	(0.5%)	(0.4%)

THERE IS A SUSTAINED MARKET REACTION TO DIVIDEND BEHAVIORS

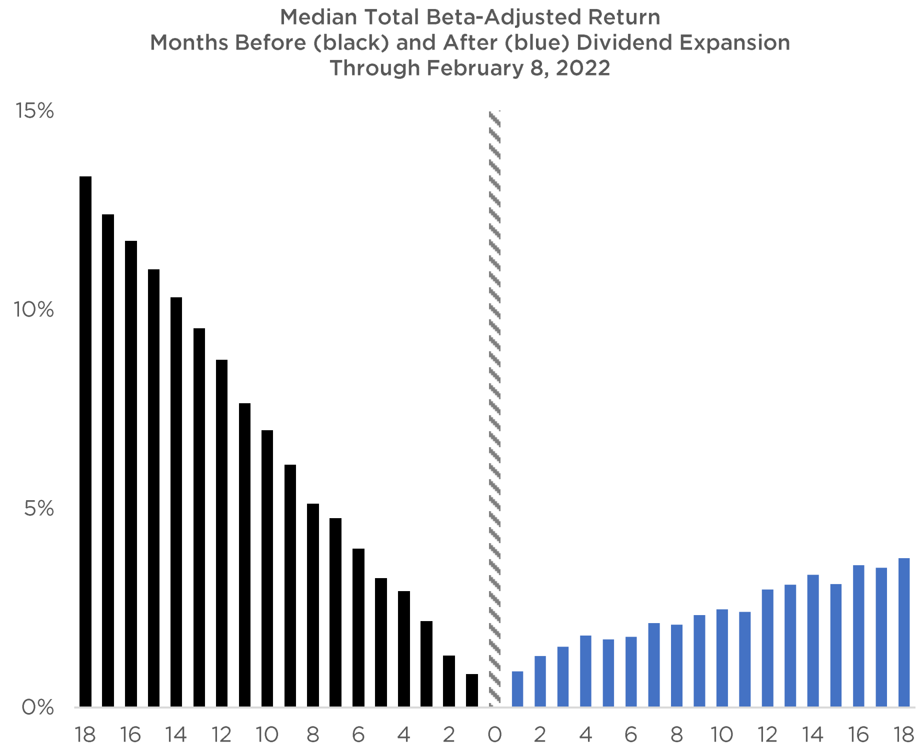
We studied the short-term behavior of companies initiating or expanding their dividends since 1999. Expanders continued to outperform for three weeks after their dividend increase in aggregate (left), even though they also outperformed on average prior to the announcement. This indicates that it is not too late on average to invest following the announcement. Similarly, companies that initiate a dividend, continue to outperform for 15 days following the announcement (right).

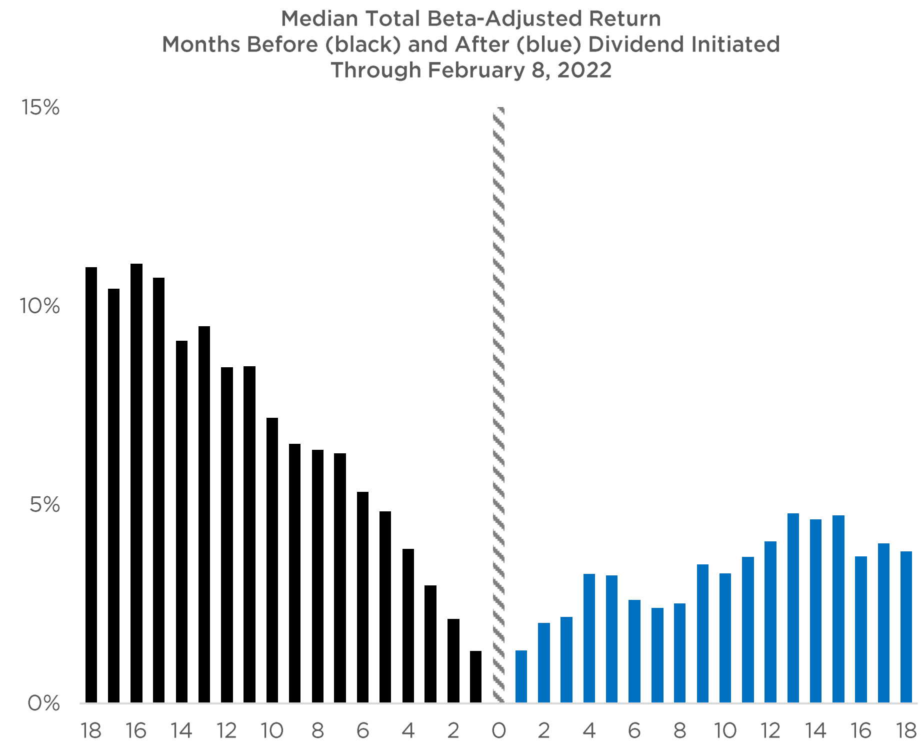




ALPHA PEAKS 12-TO-18 MONTHS LATER FOR THESE STRATEGIES

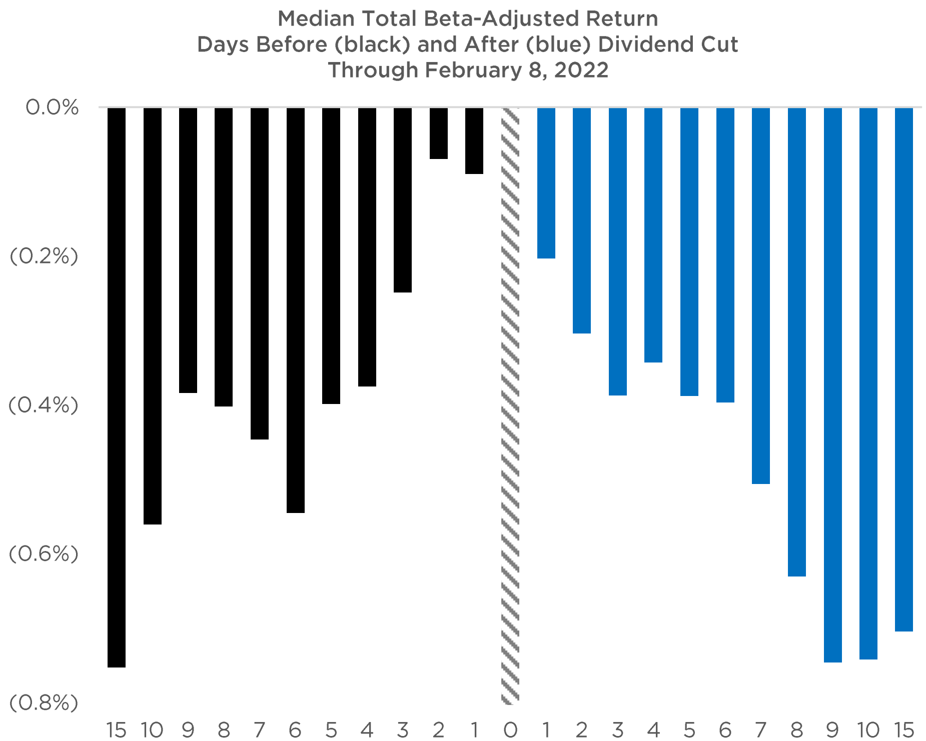
Over the long-term, outperformance continues for expanders for 18 months on average, even though many strongly outperform the 1.5 years prior to the expansion. Those that initiate a dividend also perform well beforehand, but alpha peaks earlier than for expanders.

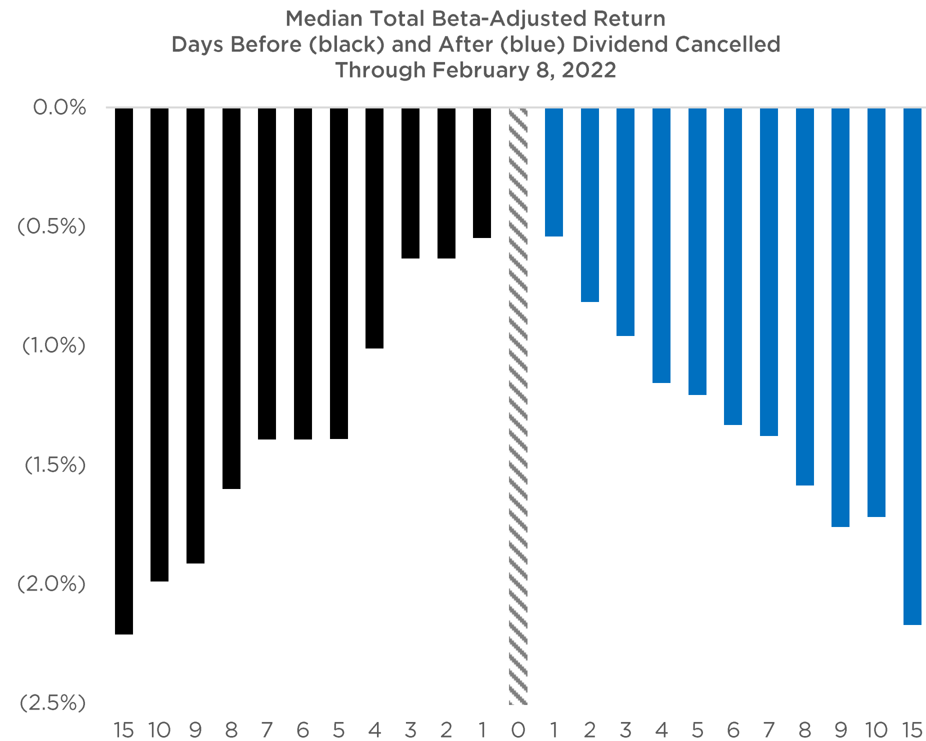




DIVIDEND CUTTING / CANCELLING DOES NOT REVERSE IMMEDIATELY

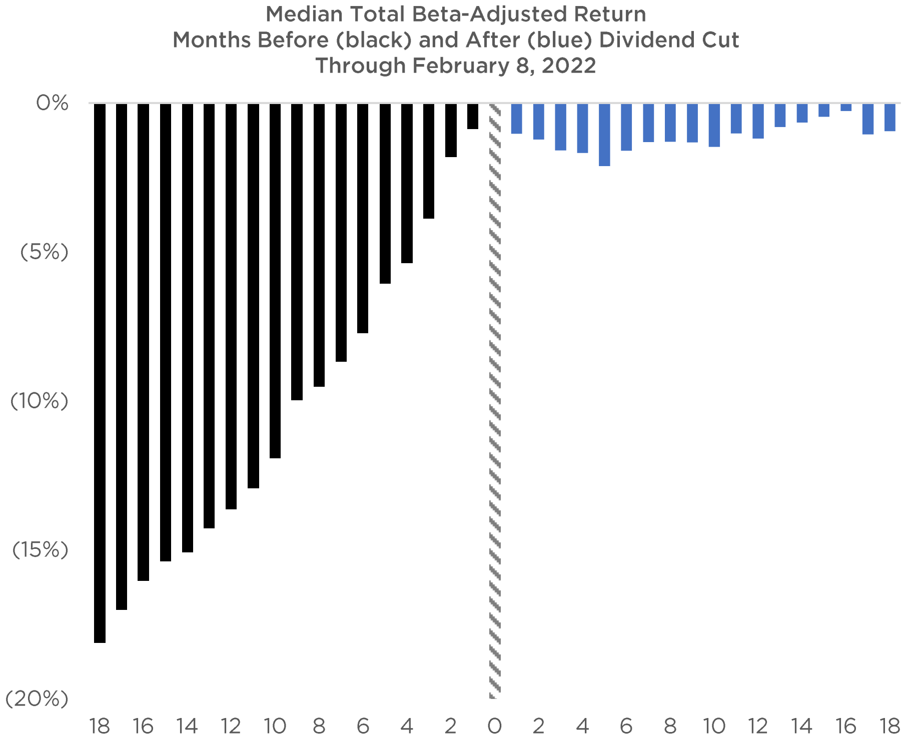
Similarly, it is not too late to sell cutters (left) or cancellers (right). Stocks that announce a dividend cut lag prior to their announcement, but trough nine days after the announcement. Dividend cancellers lag by 200bps on a beta-adjusted basis for the ten trading days prior to announcing a cut. They then lag another 150bps on a beta-adjusted basis beyond the initial one-day reaction over the next 15 days on average.

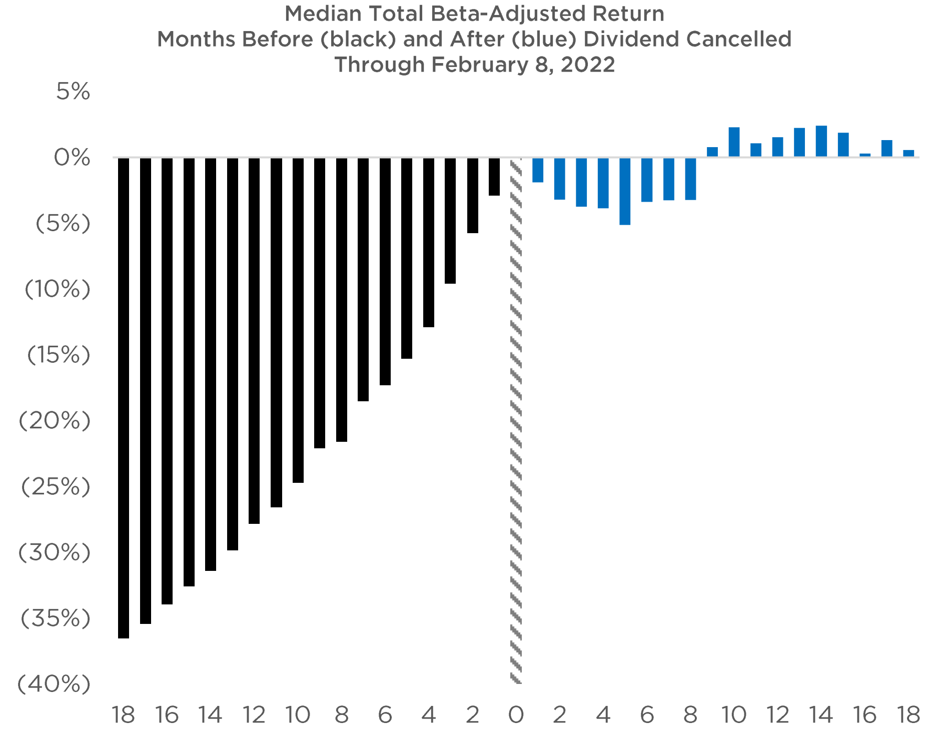




BUT MAY NOT BE A LONG-TERM SHORT STRATEGY

Shorting cutters (left) and cancellers (right) over a longer-term horizon, is not as strong of a strategy as buying is for expanders / initiators. Dividend cutters and cancellers STRONGLY underperform prior to their announcements and drag negative alpha for about five months more for both on average. Cancellers (who survive) start to beat the market by nine months after their announcement on average.





SIGNALS TO PICK WINNERS FROM LOSERS AMONG DIVIDEND YIELDERS

We have two quantitative models that specifically forecast returns among high dividend-yielding stocks, one for junk and one for everything else. The signals and comments are shown below. Overall, the high yield junk model is more focused on balance sheet trends that help with dividend coverage, valuation, and avoiding heavily shorted stocks (where the short thesis is often a pending dividend cut or cancellation). Our non-junk high yield model is more focused on income statement and stability. Said another way, the non-junk high yield model is focused on “offense” and the high yield junk model on “defense” when it comes to dividends.

High Yield Model Signals

Junk	
Signal Name	**Comment**
Free Cash Flow Yield	Buy cheap on free cash flow and short expensive
Price-to-Forward Earnings	Buy cheap on forward earnings and short expensive
Dividend Coverage	Buy those where net income is far greater than dividend payout, short those where it is close
Dividend Growth	Buy those growing their dividend, short those that are not
EPS Growth over Last 12Q	Buy those with good earnings growth over the last three years, short those with low
Forecasted Revenue Growth	Buy those forecasted to grow revenue
Short Interest to Value Traded	Buy those with low short interest, short those with high short interest
Quick Ratio Growth	Buy those growing their quick ratio (short term balance sheet trends are improving)
YoY Growth in Receivables	Buy those with stable receivables, short those with volatile receivables

Non-Junk	
Signal Name	**Comment**
Price-to-EBITDA	Buy cheap and short expensive
Indicated Dividend Growth	Buy higher indicated yield and short lower (this is all among only high yielders)
Capex to Sales Growth	Buy low capital intensity and short high capital intensity
Momentum over last 126d	Buy stocks with good momentum, short those with bad
Short Interest to Float Cap.	Buy those with low short interest, and short those with high short interest
Return on Equity Growth	Buy those growing ROE, short those with low or negative ROE growth
YoY Growth in Net Income	Buy those with stable earnings growth, short those with volatile growth
YoY Growth in SGA	Buy those with stable expense growth, short those with volatile expense growth

QUANTITATIVELY-DERIVED HIGH DIVIDEND YIELD STOCK IDEAS

Buy ideas below are in the top 20% of our high yield or high yield junk models and are dividend expanders. Short ideas are in the bottom quintile of the models and are not growing their dividends (or cut / cancelled).

Buy Dividend Expanders in Top 20% of High Yield Models
Short non-Dividend Expanders in Bottom 20% of High Yield Models or Non-Growth Cutters/Cancellers in Bottom 20% of Overall Model
February 8, 2022

Longs

Ticker	Company Name	Industry Group	Market Cap ($ US. Bil)
AMGN	Amgen Inc.	Pharma Biotech	134.48
BX	Blackstone Inc.	Diversified Financials	94.22
ALLY	Ally Financial Inc.	Diversified Financials	16.60
WHR	Whirlpool Corporation	Consumer Durables & Apparel	11.83
SNA	Snap-on Incorporated	Capital Goods	11.35
OMF	OneMain Holdings, Inc.	Diversified Financials	7.06
AEO	American Eagle Outfitters, Inc.	Retailing	3.96
MDC	M.D.C. Holdings, Inc.	Consumer Durables & Apparel	3.17
GOGL	Golden Ocean Group Limited	Transportation	2.18
GES	Guess, Inc.	Retailing	1.52
RGR	Sturm, Ruger & Company, Inc.	Consumer Durables & Apparel	1.18
HESM	Hess Midstream LP	Energy	1.00

Shorts

Ticker	Company Name	Industry Group	Market Cap ($ US. Bil)
SRE	Sempra	Utilities	44.04
KHC	The Kraft Heinz Company	Food, Beverage & Tobacco	42.77
WMB	The Williams Companies, Inc.	Energy	36.95
PEG	Public Service Enterprise Group Inc.	Utilities	34.01
GPC	Genuine Parts Company	Retailing	18.53
CNP	CenterPoint Energy, Inc.	Utilities	17.73
ATO	Atmos Energy Corporation	Utilities	14.14
CPB	Campbell Soup Company	Food, Beverage & Tobacco	13.16
LUMN	Lumen Technologies, Inc.	Telecommunication Services	12.98
HAS	Hasbro, Inc.	Consumer Durables & Apparel	12.73
AEM	Agnico Eagle Mines Limited	Materials	12.02
OGE	OGE Energy Corp.	Utilities	7.56
WWD	Woodward, Inc.	Capital Goods	7.26
JHG	Janus Henderson Group plc	Diversified Financials	6.09
EVA	Enviva Inc.	Energy	4.57
VIRT	Virtu Financial, Inc.	Diversified Financials	3.87
CBT	Cabot Corporation	Materials	3.86
ATCO	Atlas Corp.	Transportation	3.84
TRN	Trinity Industries, Inc.	Capital Goods	2.92
WRE	Washington Real Estate Investment Trust	Real Estate	2.01

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